

DIRECT TESTIMONY

OF

ROBERT F. KOCH

RATES DEPARTMENT

TELECOMMUNICATIONS DIVISION

ILLINOIS COMMERCE COMMISSION

TDS METROCOM, LLC
(TDS METROCOM)

v.

ILLINOIS BELL TELEPHONE COMPANY
d/b/a (SBC ILLINOIS)

COMPLAINT CONCERNING IMPOSITION OF UNREASONABLE AND ANTI-
COMPETITIVE TERMINATION CHARGES BY ILLINOIS BELL TELEPHONE
COMPANY

DOCKET NO. 03-0553

FEBRUARY 11, 2004

1 **I. Introduction and Overview**

2

3 **Q. Please state your name and business address.**

4 A. My name is Robert F. Koch and my business address is 527 East Capitol
5 Avenue, Springfield, Illinois 62701.

6

7 **Q. By whom are you employed and in what capacity?**

8 A. I am employed by the Illinois Commerce Commission ("Commission") as
9 an Economic Analyst in the Rates Section of the Telecommunications
10 Division.

11

12 **Q. Please describe your educational and occupational background.**

13 A. I received a Bachelor of Science degree in Mathematics and Economics
14 from Illinois State University in 1992. In May of 1997, I received a Master
15 of Science degree in Economics from Illinois State University. During the
16 Summer of 1996, I worked as an intern in the Telecommunications Rates
17 Section of the Public Utilities Division with the Commission. Upon
18 graduation, I accepted a position with the Commission as an Economic
19 Analyst in the Rates Section of the Telecommunications Division.

20

21 **Q. Please briefly describe your duties with the Illinois Commerce**
22 **Commission.**

23 A. My responsibilities include reviewing wholesale and retail tariff filings of
24 both competitive and non-competitive telecommunications services,
25 providing support to other Commission Staff, and analyzing cost study
26 issues in docketed cases that have cost of service and rate implications. I
27 am also responsible for reviewing the managerial, technical, and financial
28 capabilities of companies seeking approval to do business in Illinois as
29 competitive local exchange carriers.
30

31 **Q Have you previously testified before the Commission?**

32 A. Yes. I have provided expert witness testimony in several docketed cases:
33 I.C.C. Docket No. 96-0503 (GTE wholesale rate docket); I.C.C. Docket
34 Nos. 97-0601/0602/0516 (Consol.)(access charge reform, etc.); I.C.C.
35 Docket No. 97-0633 (interim local number portability cost recovery); I.C.C.
36 Docket No. 98-0200/0537 (complaint investigating GTE Usage Sensitive
37 Service rates); I.C.C. Docket No. 98-0252/0335 (Consol.) (Ameritech 5
38 year alternative regulation review); I.C.C. Docket No. 98-0860 (Ameritech
39 competitive service reclassification); I.C.C. Docket Nos. 99-0038/0039
40 (Consol.) (access charge refunds for IXCs); I.C.C. Docket No. 99-0185
41 (Ameritech alternative regulation Annual Filing); I.C.C. Docket No. 99-
42 00315 (infrastructure maintenance fee adjustments); I.C.C. Docket No. 99-
43 0412 (Geneseo EAS petition); I.C.C. Docket No. 99-0544 (ATS Services
44 certification case); I.C.C. Docket No. 00-0043 (Cub complaint of Ameritech
45 usage plans); I.C.C. Docket No. 00-0187 (GTE sale of assets to Citizens

Telecommunications Company of Illinois); I.C.C. Docket No. 00-0023 (complaint investigating Ameritech's termination penalties); I.C.C. Docket No. 00-0233/0335 (Consol.) (Phase I and Phase II); I.C.C. Docket No. 00-0393 (initial and rehearing investigation of Ameritech's line sharing tariff), I.C.C. Docket No. 00-0812 (Phase I of Verizon cost docket); I.C.C. Docket No. 01-0662 (Phase I of Ameritech Section 271 checklist compliance docket); I.C.C. Docket No. 02-0247 (Phase I of investigation into Ameritech access charges); I.C.C. Docket No. 02-0864 (SBC UNE rate investigation); I.C.C. Docket No. 03-0726 (wireless LNP requirement suspension for Egyptian); I.C.C. Docket No. 03-0730 (wireless LNP requirement suspension for Madison Telephone); I.C.C. Docket No. 03-0731 (wireless LNP requirement suspension for Harrisonville Telephone); I.C.C. Docket No. 03-0732 (wireless LNP requirement suspension for Alhambra-Grantfork Telephone); and I.C.C. Docket No. 03-0733 (wireless LNP requirement suspension for Home Telephone).

Q. What is the purpose of your Direct Testimony in this proceeding?

A. The purpose of my testimony is to evaluate the termination liability proposals supported by the testimony of TDS Metrocom ("TDS") witness Matthew Loch and SBC Illinois ("SBCI") witness Brian Gillespie. I also address the cost testimony sponsored by SBC Illinois witness Ronald Flitsch. I conclude that the most appropriate way of addressing the concerns of all parties is for the Commission to simultaneously accept

69 SBCI's proposed modifications to its termination liability policy as an
70 interim measure and initiate a rule-making proceeding to establish
71 industry-wide standards for these charges.

72 **II. Discussion of Each Party's Proposal**
73

74 ***TDS' Proposal***
75

76 **Q. Please describe your understanding of TDS' proposal.**

77 A. TDS proposes that SBCI adopt termination liability charges similar to
78 those that SBCI was required to implement for certain ValueLink and
79 CompleteLink offerings in compliance with the Order in ICC Docket 00-
80 0024 ("Ascent Order"). In the Ascent Order, SBCI was required to adopt
81 termination penalties that were based strictly on the amount of discount
82 received by the customer up to the point of termination. Specifically, the
83 termination charge was to be calculated by determining the discount for
84 which the customer would have satisfied under a term contract, and
85 subtracting the difference between it and the discount it had actually
86 received. This is in stark contrast to SBCI's traditional method of
87 calculating the termination liability based as a percentage of the remaining
88 revenue commitment on the contract.
89

90 **Q. What is your opinion regarding this proposal?**

91 A. I believe that the TDS proposal is reasonable to the customer and has a
92 positive impact on competition in SBCI's service territory. In fact, the TDS

93 proposal is very similar to the termination liability that I recommended in
94 the Ascent proceeding, ICC Docket 00-0024.

95

96 **Q Do you have any concerns regarding the termination liability**
97 **proposal of TDS?**

98 A. Yes. First, placing excessive restrictions on the ability of SBCI to impose
99 termination penalties could potentially negatively impact customers. Such
100 limits on penalties make it less attractive for a carrier such as SBCI to
101 develop discount offerings. The term of the contract, and the penalty
102 associated with it, provides revenue stability for a carrier. It is this revenue
103 stability benefit to the carrier that makes it worthwhile to offer discounts to
104 the customer. By severely limiting the revenue stability benefit to SBCI,
105 the discount benefit to SBCI customers will be less likely to come to
106 fruition.

107

108 Second, I am concerned with the issue of fairness. Placing such
109 requirements on SBCI, while allowing all other carriers in the market
110 complete freedom to charge whatever termination penalties they feel are
111 appropriate, does not appear to be a fair policy. As part of my job
112 responsibilities, I review tariffs for telecommunications carriers. I was
113 involved in the data collection process that resulted from the Ascent Order
114 in Docket 00-0024. From these experiences, I discovered that most
115 carriers have implemented termination penalties at the level of 100% of

the remaining revenue commitment for contracts. Subsequent to the completion of the data collection process, Staff was successful at getting a handful of these carriers to reduce their termination liability penalties to 35%. These percentages have thus become, for better or worse, standard in Illinois. By accepting the TDS proposal, SBCI would not be allowed the latitude to offer similar termination penalties.

SBCI's Proposal

Q. What is your opinion of the SBCI's proposal?

A. SBCI seeks to change its termination liability policy to cap the percentage by which it would enforce tariffed and contracted term plans in the future. The reductions appear to be significant and are likely to have a positive impact on any customer that chooses to terminate its obligations to the carrier. The SBCI proposal would also appear to have the positive impact of promoting competition to the extent that it becomes viable for a customer to switch to another carrier.

Additionally, it is my opinion that SBCI's proposal would produce a more significant termination liability than the TDS proposal in almost all circumstances. Because the TDS proposal is based on previous discounts received and the SBCI proposal is based on forward-looking revenue commitments, the termination liability is not easily comparable. However, it stands to reason that, even at the 25% level, SBCI's penalties

140 will be more severe than TDS' penalties up until the final months of the
141 contract term. As is discussed later in this testimony, I am concerned that
142 SBCI's termination liability proposal could still have a significant negative
143 impact on the ability of competitive carriers to obtain the business of
144 customers on contract with SBCI.

145

146 **Q. Please provide an example of how SBCI's proposal might produce**
147 **termination penalties in excess of TDS proposal.**

148 A. Assume that a Centrex customer wants to terminate its contract with SBCI
149 upon completion of the second year of a three year contract, and that the
150 customer would have to pay 25% of minimum annual revenue
151 commitment as a termination penalty. Additionally, assume that under this
152 three year contract, the customer currently receives a 20% discount on its
153 services and that a one year contract would have offered the customer a
154 10% discount. Under the TDS proposal, the customer would only be liable
155 for the difference between its currently received 20% discount and that of
156 the discount it would have otherwise qualified for, the 10% discount for a
157 one year contract. The result is that the customer would ultimately have to
158 relinquish 10% of the discount it had received over the two years it was on
159 contract, and therefore would be liable for 20% of its annual revenue
160 commitment in total. This example illustrates that, under the reasonable
161 assumptions outline above, the SBCI proposal results in a higher
162 termination penalty than the TDS proposal.

163

164 **Q. Is it your opinion that the example provided above is for a typical**
165 **consumer?**

166 A. No. The example is only a comparison of the two types of termination
167 liabilities under reasonable assumptions. With the plethora of SBCI term
168 contract and tariff options available to customers, I would not know where
169 to begin defining a typical customer. It is my opinion that, in most cases,
170 the TDS termination liability proposal would be more favorable to
171 customers than the SBC proposal. I am also certain that SBCI could
172 produce examples where its proposal is more favorable to customers
173 under certain circumstances, such as during the last few months of a
174 lengthy term contract.

175

176 **Q. Does SBCI provide rationale for the termination liability limits that it**
177 **proposes?**

178 A. Yes. SBCI witness Gillespie indicates that termination liability should be
179 commensurate to the losses incurred by the company. He then defers to
180 SBCI witness Ronald Flitsch for calculations to justify the percentages of
181 revenue commitment that the company is proposing to implement.

182

183 **Q. What is your opinion of the calculations provided by Mr. Flitsch?**

184 A. It is my understanding that Mr. Flitsch's calculations are simply an
185 estimation of the profit the company would receive, on average, from

186 customers of the three different types of service classifications defined by
187 the company in this proceeding. Mr. Flitsch presents profit estimations
188 using three distinct methodologies for each contract category.¹ The first
189 methodology is to use aggregate revenue and cost data to get a broad
190 measure of the profit for each category. The second methodology is to
191 determine the estimated profit by determining the typical customer
192 configuration and then applying these assumptions to the tariffed rates
193 and service specific long run service incremental costs ("LRSIC")
194 information. The third method was to sample actual ICB contracts to
195 generate average revenue and LRSIC amounts for each category.

196
197 In each of the three methodologies used by Mr. Flitsch, only profit levels
198 are estimated. As SBC witness Gillespie justifies the company's
199 termination penalties solely on the basis of these calculations, it would
200 appear that SBCI is claiming that no additional costs are being incurred
201 when contracts are terminated early. Rather, the entire loss that the
202 company is trying to recover is actually lost profit. In other words, SBCI's
203 proposal provides the company a mechanism by which it guarantees itself
204 revenue commensurate to the average profit it would have received had it
205 not lost the customer to competition prior to the completion of the contract
206 term.

¹ SBCI Exhibit 3.0, Schedule RF-1.

208 **Q. What is your opinion regarding the accuracy of the calculations**
209 **presented by SBCI witness Flitsch?**

210 A. Each of Mr. Flitsch's methodologies are flawed to some extent. Although
211 not explicitly stated, I believe that SBCI provided three methodologies as
212 the basis for its recommendations instead of just one for this very reason.
213 Although verifiable data was used in two of the three methodologies, I
214 question these estimates as they are highly dependent on assumptions
215 that are not as easily verifiable.

216

217 **Q. What is your concern regarding the first methodology?**

218 A. The first methodology uses data from SBCI's aggregate revenue test,
219 which is submitted annually to the Commission with SBCI's annual
220 alternative regulation proceeding. It is my understanding that the data
221 used by Mr. Flitsch includes revenues for services that are a part of term
222 contracts, at discounted rates, as well as services that are ordered *ala*
223 *carte* out of SBCI's tariffs at premium rates. Therefore, the averages
224 calculated using these revenue figures would necessarily be higher than
225 they would be if the average were calculated using only revenue for
226 services that are in term contracts. Mr. Flitsch acknowledges this fact as
227 well.²

228

² SBC Illinois Exhibit 3.0 at 4 ("[S]ince customers taking service pursuant to term arrangements receive discounts off of standard, month-to-month rates, the contribution levels are lower on these plans.").

229 **Q. What is your concern regarding the second methodology?**

230 A. My concern is that the assumptions used to derive the LRSIC and revenue
231 figures used in the second methodology are not quite clear. I have been
232 unable to verify the reasonableness of these assumptions. If these
233 assumptions serve to lower the average LRSIC for a particular contract
234 category, the result is an inflated percentage for which to calculate
235 termination liability. Further, Mr. Flitsch does not even indicate what the
236 typical customer assumptions are for any services other than Centrex.

237

238 **Q. What is your concern regarding the third methodology?**

239 A. I generally agree with the approach of sampling contracts as described by
240 Mr. Flitsch. My only concern is that verification of such methodology is
241 difficult to perform.

242

243 **Q. Can SBCI's proposed termination penalties be viewed as a barrier to**
244 **competitive entry?**

245 A. As the example that I provided previously in this testimony illustrates,
246 SBCI's proposal may make it prohibitive for a competing carrier to acquire
247 the customer, depending on the number of months remaining on the
248 contract. To make it worthwhile for a customer to want to switch carriers,
249 a CLEC would probably need to offer deeper discounts than what SBCI
250 offers to the customer. All else being equal, it is safe to assume that the
251 profit margin received by the CLEC would be less than that received by

SBCI for the provisioning of the same services. Factoring in a significant termination penalty as well, the CLEC is surely in a disadvantageous position. Because SBCI's proposed termination penalties are proportional to the remaining term of the contract, logic dictates that the CLEC profit margin is inversely proportional to the remaining term of the contract if it assumes this liability as a cost of acquiring the customer. At the same time, SBCI is guaranteed a certain level of profit regardless of whether or not it loses the customer.

III. Summary and Recommendations

Q. Please summarize the arguments you have made in this Direct Testimony.

A. The discussion in this testimony makes it clear that there are positive and negative aspects to both TDS' and SBCI's proposals. If the TDS proposal were accepted, the customers benefit because their liability is reduced and the competitive options are improved. However, these benefits come at the expense of providing less incentive for SBCI to offer attractive discounts to customers and by requiring that SBCI be subject to a higher standard than its competitors.

If the SBCI proposal is accepted, customers benefit because termination liabilities will be decreased from current levels and the company benefits because it is not treated unfairly in the marketplace and it is guaranteed a certain level of profit regardless of whether the contract is honored to

276 completion. However, CLECs suffer because SBCI's termination penalties
277 continue to restrict customer migration to some extent.

278

279 **Q. Do you have a recommendation at this time?**

280 A. Yes. To balance the various concerns represented in this proceeding, I
281 recommend a two-part solution as my first alternative. I recommend that
282 the Commission accept SBCI's proposal as an interim measure, coupled
283 with a finding that a rule-making proceeding be initiated to establish
284 industry-wide guidelines. This proposal provides some relief to customers
285 and competitors, and does not impose an unfair constraint upon SBCI.
286 Recognizing that lingering concerns regarding competition cannot be
287 ignored, whether it is via SBCI's termination penalties or those of another
288 carrier, any permanent solution should involve the entire industry.

289

290 **Q. Are there any other benefits that the Commission might want to**
291 **consider regarding a rule-making proceeding?**

292 A. Yes. First, although a rule-making proceeding would be a large-scale
293 endeavor, I believe that it would potentially reduce the burden on the
294 Commission over time. Without a rule in place regarding termination
295 penalties, I fear that the Commission will be confronted with similar
296 petitions as the instant complaint as competition continues to increase.
297 The fact that TDS was prompted to file this petition even after SBCI
298 complied with the Order in Docket 00-0024 lends support to this argument.

299 I would anticipate that competitive carriers would also be concerned with
300 the termination penalties of LECs other than SBCI in the future as well. A
301 well-crafted rule, however, would mitigate the need for similar petitions as
302 the instant complaint on a going-forward basis. Second, if the
303 Commission desires to address the issue of competitive carriers'
304 termination penalties, it may be difficult to do so without a rule making.
305

306 **Q. If the Commission does not want to open an industry-wide**
307 **rulemaking proceeding, do you still recommend that SBCI's proposal**
308 **be accepted?**

309 A. No. SBCI's proposal is an interim solution at best. As I have indicated in
310 this testimony, although SBCI's proposed termination liability policy is an
311 improvement, it is still structured in a way that significantly limits the ability
312 of its competitors to attract customers. An industry-wide rule-making
313 proceeding provides a fair means by which to further explore the most
314 appropriate level of termination penalties. Without assurance that such an
315 undertaking would take place, I would recommend that the TDS proposal
316 be implemented. Under the TDS proposal, my concerns regarding the
317 impact on competition go away. Although a side-effect of accepting the
318 TDS proposal is that there would be less incentive for SBCI to offer its
319 customers extensive discounts in the future, it is my opinion that improved
320 ability of customers to migrate to competitive carriers outweighs this cost.
321 I emphasize that this as a second-best solution, and only recommend that

322 the Commission accept it in the case that it decides not to order that a
323 rule-making proceeding be undertaken in this proceeding.

324

325 **Q. Does this conclude your testimony?**

326 **A. Yes.**